STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0092
TELEPHONE (916) 324-1825
FAX (916) 322-4530
www.boe.ca.gov

May 19, 2006

Dear Interested Party:

Enclosed is the *Initial Discussion Paper on Regulation 1603, Taxable Sales of Food Products*, regarding the application of tax to tips and gratuities. Discussion regarding proposed amendments to Regulation 1603 is scheduled for the Board's **September 26, 2006 Business Taxes Committee** meeting.

However, before the issue is presented at the Business Taxes Committee meeting, staff would like to provide interested parties an opportunity to discuss the issue and present any suggested changes or comments. Accordingly, a meeting is scheduled in **Room 122 at 10:00 A.M. on June 1, 2006**, at the Board of Equalization; 450 N Street; Sacramento, California.

If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 322-4530 before the June 1 meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on June 1, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Ms. Cecilia Watkins at (916) 445-2137 or by e-mail at Cecilia.Watkins@boe.ca.gov prior to May 30, 2006. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing. In addition, please let Ms. Watkins know if you wish to have future correspondence, including the second discussion paper and all attachments, sent to your e-mail address rather than to your mailing address.

Whether or not you are able to attend the above interested parties' meeting, please keep in mind that the due date for interested parties to provide written responses to staff's analysis is **June 19, 2006.** Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Business Taxes Committee" page on the Board's Internet web site (http://www.boe.ca.gov/meetings/btcommittee.htm) for copies of Committee discussion or issue papers, minutes, a procedures manual and calendars arranged according to subject matter and by month.

Thank you for your consideration. I look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Leila Khabbaz, Supervisor, Business Taxes Committee at (916) 322-5271.

Sincerely,

Jeffrey L. McGuire
Chief, Tax Policy Division
Sales and Use Tax Department

JLM: caw

Enclosures

cc: (all with enclosures)
Honorable John Chiang, Chair
Honorable Claude Parrish, Vice Chairman
Ms. Betty T. Yee, Acting Member, First District (MIC 71)
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable Steve Westly, State Controller, C/O Ms. Marcy Jo Mandel (MIC 73)
Mr. Chris Schutz, Board Member's Office, Fourth District (MIC 72)
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Mr. Romeo Vinzon, Board Member's Office, Third District (via e-mail)
Ms. Mira Tonis, Board Member's Office, First District (via e-mail)
Mr. Steve Kamp, Board Member's Office, First District (MIC 71)
Ms. Margaret Pennington, Board Member's Office, Second District (via e-mail)
Mr. Lee Williams, Board Member's Office, Second District (MIC 78 and via e-mail)
Mr. Ramon J. Hirsig (MIC 73)
Ms. Kristine Cazadd (MIC 83)
Ms. Randie L. Henry (MIC 43)
Mr. Robert Lambert (MIC 82)
Mr. Randy Ferris (MIC 82)
Ms. Sharon Jarvis (MIC 82)
Mr. Cary Huxoll (MIC 82)
Ms. Janice Thurston (via e-mail)
Ms. Jean Ogrod (via e-mail)
Mr. Jeff Vest (via e-mail)
Mr. David Levine (MIC 85)
Ms. Elizabeth Abreu (via e-mail)
Mr. Steve Ryan (MIC 85)
Mr. Todd Gilman (MIC 70)
Mr. Dave Hayes (MIC 67)
Ms. Freda Orendt (via e-mail)
Mr. Stephen Rudd (via e-mail)
Mr. Joseph Young (via e-mail)
Mr. Vic Anderson (MIC 44 and via e-mail)
Mr. Larry Bergkamp (via e-mail)
Mr. Cornell Yip (via e-mail)
Mr. Geoffrey E. Lyle (MIC 50)
Ms. Leila Khabbaz (MIC 50)
Ms. Cecilia Watkins (MIC 50)
Ms. Lisa Andrews (MIC 50)

INITIAL DISCUSSION PAPER

Proposed Revisions to Regulation 1603, *Taxable Sales of Food Products*, Regarding the Application of Tax to Charges for Mandatory and Optional Gratuities

Issue

Should Regulation 1603, *Taxable Sales of Food Products*, be amended to clarify the application of tax to charges for mandatory and optional gratuities?

A copy of Regulation 1603 is attached as Exhibit 1.

Background

At its November 1, 2005 meeting, the Board of Equalization (Board) heard a case involving the application of tax to tips and gratuities. At issue was whether gratuity charges added by restaurants to customers' checks were optional where a menu notice indicated that the gratuities were voluntary but would be added to the checks. The Board's policy generally has treated a gratuity added to the bill by the retailer as mandatory, even when a statement on the menu or bill indicates that the gratuity is optional. An amount added to the bill by the customer for a gratuity generally is assumed to be optional.

In addition to the discussion at the Board hearing regarding mandatory versus optional charges, the taxpayer suggested that since California Labor Code section 351 provides that no employer or agent may collect, take or receive any part of any gratuity that is paid, given to or left for any employee by a patron, there is no basis for the Board to require the retailer/employer to pay sales tax on such amounts. A copy of Labor Code sections 350-356 is attached as Exhibit 2.

The taxpayer also suggested that since the regulatory language regarding voluntary versus mandatory gratuities is published in subdivision (h), *Caterers*, of Regulation 1603, its provisions do not apply to sales by restaurants.

The Board directed staff to review this issue and clarify Regulation 1603 where needed. The Business Taxes Committee is scheduled to discuss this issue at its meeting on September 26, 2006.

Discussion

<u>Mandatory and optional tips</u>

California imposes sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state, unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code, §6051.) This tax is imposed on the retailer, who may collect tax reimbursement from the customer if the contract of sale so provides. (Civ. Code, §1656.1; Cal. Code Regs., tit. 18, §1700, subd. (a)(1).)

Unless otherwise exempted by statute, taxable gross receipts include all amounts received with respect to the sale, with no deduction for the cost of materials used, labor or service costs, or any other expense of the retailer passed on the customer. (Rev. & Tax. Code, §6012, subd. (a)(2).)

INITIAL DISCUSSION PAPER

Proposed Revisions to Regulation 1603, *Taxable Sales of Food Products,* Regarding the Application of Tax to Charges for Mandatory and Optional Gratuities

With respect to retailers that make taxable sales of food products, Sales and Use Tax Regulation 1603 provides that:

> (g) TIPS AND SERVICE CHARGES. No employer shall collect, take, or receive any gratuity or a part thereof, paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of such gratuity, or require an employee to credit the amount, or any part thereof, of such gratuity against and as a part of the wages due the employee from the employer. (Labor Code Section 351.) If this prohibition is violated, any amount of such gratuities received by the employer will be considered a part of the gross receipts of the employer and subject to the tax.
>
> Amounts designated as service charges, added to the price of meals are a part of the selling price of the meals and, accordingly, must be included in the retailer's gross receipts subject to tax even though such service charges are made in lieu of tips and are paid over by the retailer to employees.

Although discussed in the context of transactions involving caterers, Regulation 1603(h)(3)(E) also casts further light on the Board's interpretation of when tips and gratuities are subject to tax as follows:

> (E) Tips, Gratuities, or Service Charges. An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts. A tip, gratuity, or service charge negotiated in advance of an event between the caterer and the customer is mandatory even though the amount or percentage is negotiated. A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as "optional gratuity." A gratuity is optional only if it is voluntarily added by the customer.
>
> Examples of mandatory tips, gratuities, or service charges include:
>
> > "A 15% gratuity [or service charge] will be added to parties of 8 or more."
> >
> > "Suggested gratuity 15%," itemized on the invoice or bill by the caterer.
>
> Tips, gratuities, and service charges are further discussed in subdivision (g).

Under the heading of "Restaurant Auditing," section 0809.20 of the Board's Audit Manual summarizes the relevant authority from Regulation 1603 in this way:

> No employer shall collect, take, or receive any gratuity or part thereof, paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of such gratuity, or require an employee to credit the amount, or any part thereof, of such gratuity against and as a part of the wages due the employee from the employer. (Labor Code section 351.) If this prohibition is violated, any amount of such gratuities received by the employer will be considered a part of the gross receipts of the employer and subject to tax.
>
> Optional tips are not included in gross receipts and are not subject to tax.

> Mandatory tips, such as those applied by a restaurant when a party exceeds a specific number of patrons, are considered part of gross receipts and subject to tax. Each restaurant may have its own policy with respect to the specific number of patrons necessary before a charge for tipping is mandatory. Ex: "A 17% gratuity will be added to parties of 8 or more."
>
> The auditor should discuss tipping with the taxpayer and if necessary examine the taxpayer's payroll records as verification of the taxpayer's policies.

The Board has taken the position that when a restaurant or caterer adds service charges, tip or gratuity to the bill, such charges do not meet the test of voluntary and should be included in taxable gross receipts. (See Sales and Use Tax Annotations 550.0695 (3/21/95) and 550.0740 (9/22/53).)

The same rule applies when the retailer includes a service charge with the bill, and adds a statement advising the customer that the charge may be raised, lowered, or eliminated. (See Sales and Use Tax Annotation 550.0715 (8/26/96). Retailers have claimed that amounts shown as gratuities on customers' bills are only shown in an effort to be more "customer-friendly" and to facilitate the calculation of tips. Under these circumstances, the question becomes whether the situation creates an "optional" gratuity, shown only to assist the customer, or whether the gratuity is mandatory because it was added by the retailer rather than the customer, notwithstanding the fact that the customer may choose to increase or reduce the amount.

Regulation 1603, subdivisions (g) and (h)(3)(E)

The application of tax to tip and gratuity charges is included in two separate subdivisions of Regulation 1603: Subdivision (g), *Tips and Service Charges*, and subdivision (h)(3)(E), under the heading "*Caterers*." Some taxpayers have asserted that the provisions of subdivision (h)(3)(E) were limited to caterers and did not apply to sales by restaurants. While subdivision (g) has been part of the regulation for a long time, subdivision (h)(3)(E) was added in 2002 as part of the revisions regarding sales by caterers. However, as reflected in the Board's various publications prior to 2002 and in the Board's Audit Manual, the provisions are applicable to all sellers of meals. To avoid further misinterpretation, staff proposes to delete subdivision (h)(3)(E) and incorporate its provisions in subdivision (g) with cross-references in the appropriate subdivisions.

Interested party proposal

On April 25, 2006, Ms. Lara Diaz Dunbar, Vice President, Government Affairs & Public Policy of the California Restaurant Association (CRA), submitted written comments echoing the views the taxpayer expressed at the November 1, 2005 Board hearing. CRA's full submission is attached as Exhibit 3.

In relevant part, CRA provides the following comments:

> Historically, the Board has taken the position that "voluntary" tips are not subject to sales tax and "mandatory" tips are taxed. Board auditors have taken the position that almost any statement by the restaurant owner with regard to tipping shifts the psychology of the customer from a purely voluntary frame of mind to a feeling of being obligated to leave a tip – thus, making the tip non-voluntary and, therefore, taxable.
>
> With regard to the Board audits, the problem arises, generally, in the case of tips left by large dining room parties. Often, a restaurant owner will, as a protection for his employees, print a statement on the menu to the extent that "An X% Gratuity/Tip May/Will be Added to the Bill for Parties Larger Than Y Individuals." Board auditors have claimed that this statement "obligates" the customer to pay a tip and makes the tip subject to sales tax.
>
> We believe these distinctions are made moot by the fact that tips are the property of the employees of the restaurant and, as such, are not subject to a sales tax imposed on the restaurant owner by the Board. [Emphasis deleted in this paragraph.]
>
> State Labor Code section 351 clearly provides that *any* amount of tip/gratuity left by patrons is the property of the employees for whom the gratuity was left and *no portion* may be kept by the restaurant owner for any reason. Further, recent changes in Section 351 strengthen the employees[']claim on all types of tips, including tips left by means of a credit card.
>
> [¶] … [¶]
>
> In other words, under new law *all* tips left by customers (whether "voluntary" or not) are not the property of the restaurant owner and must be passed on to the employees. We believe the law prevents the Board from imposing on restaurants a retail sales tax on property (i.e., tips and gratuities) that belongs to employees and to which the restaurants have no right whatsoever.
>
> [¶] … [¶]
>
> With the recent amendments to Labor Code Section 351 making it clear that ANY AND ALL tips and gratuities belong solely to the employees and cannot be retained by the restaurant owner, we believe it is time for the Board to amend its regulations and audit procedures to reflect the current state of the law. We believe the adoption of the following policy will accurately reflect the restaurant dining room setting and will accurately apply the statutory provisions of the Sales and Use Tax Law:

- The amount of gratuities negotiated prior to a meal and added to the price of the meal should be included in gross receipts subject to tax; [and]
- A gratuity authorized by a restaurant patron whether printed on a credit card receipt or handwritten on a receipt should be excluded from gross receipts subject to tax so long as it is not added to the price of the meal and is merely added to restaurant bill[.]

Labor Code Sections 350 through 356

As noted above, the CRA states that California Labor Code section 351 requires that any amount left by a restaurant customer as a tip or gratuity becomes the property of the employees of the restaurant. Based upon this, the CRA asserts that the law prevents the Board from including any tips in a restaurant's taxable gross receipts. The California Court of Appeals addressed the relationship between the provisions of Labor Code sections 350-356 and the provisions of the Revenue and Taxation Code in *Rihn v. Franchise Tax Board* (1955) 131 Cal.App.2d 356 (hereafter *Rihn*), In *Rihn*, the court held that:

> It will be noted that this article 1 of chapter 3 does not relate to taxation; that its declared purpose is "to prevent fraud upon the public in connection with the practice of tipping." . . . [¶] . . . It is to be harmonized with the Revenue and Taxation Code [citations], each being limited to its own declared sphere of influence. And the phrase "as used in this article" carefully limits the field of application of sections 350-356 to the matter of tipping in relation to the public. [¶] . . . [¶] Appellant's counsel stresses the concluding sentence of section 356, which is: "As a part of the social public policy of this State, this article is binding upon all departments of the State." He argues that the Franchise Tax Board is a department of the state and hence obligated to treat tips as gifts, thus precluding their taxation. The short and sufficient answer is that sections 350-356 are binding upon all departments of the state when operating within the field delineated by that article of the Labor Code, and only when there operating.
>
> (Rihn, 131 Cal.App.2d at pp. 365-366.)

In other words, the concluding sentence of Labor Code section 356, which declares that "as a part of the social policy of this State, this article is binding upon all departments of this State," obligates neither the Franchise Tax Board to treat tips and gratuities as nontaxable income nor the Board to treat mandatory tips and gratuities as excluded from taxable gross receipts. As relevant to the issues discussed in this paper, Labor Code sections 350 through 356 are limited to the matter of tipping in relation to the public and are not concerned with the tax status of tips and gratuities. Accordingly, it is the staff's view that the amendments made in 2000 to Labor Code section 351 are of no consequence with respect to the Board's interpretation of Revenue and Taxation Code section 6012 set forth in Regulation 1603.

INITIAL DISCUSSION PAPER

Proposed Revisions to Regulation 1603, *Taxable Sales of Food Products,* Regarding the Application of Tax to Charges for Mandatory and Optional Gratuities

Summary

Under current law, a service charge made by the retailer in connection with its sale of tangible personal property is subject to tax if the sale of the property is subject to tax. A charge for tips and gratuities added by a retailer to a customer's check is regarded as a mandatory charge made in connection with the sale of meals. Tips and gratuities left by customers voluntarily are not part of the sale of the meal and are, therefore, not subject to tax. Due to concerns that there is ambiguity regarding what constitutes "mandatory" versus "voluntary" tips and gratuities, and due to the assertion that Labor Code section 351 prohibits the taxation of tips and gratuities, the Board directed staff to meet with interested parties and clarify the provisions of Regulation 1603 as needed. Staff welcomes comments and suggestions regarding this topic.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of 05/12/2006

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Regulation 1603. TAXABLE SALES OF FOOD PRODUCTS.

References: Sections 6006, 6012, 6359, 6359.1, 6359.45, 6361, 6363, 6363.5, 6363.6, 6370, 6373, 6374 and 6376.5, Revenue and Taxation Code.
Food Products Generally, see Regulation 1602.
Alcoholic Beverages, tax reimbursement when served with, see Regulation 1700.
"Free" meals with purchased meals, see Regulation 1670.
Meals served to patients and inmates of an institution, see Regulation 1503.
Vending Machines, when considered selling meals, see Regulation 1574.
Meals at summer camps, see Regulation 1506 (e).
Parent-Teacher associations as consumers, see Regulation 1597.

(a) RESTAURANTS, HOTELS, BOARDING HOUSES, SODA FOUNTAINS, AND SIMILAR ESTABLISHMENTS.

(1) DEFINITIONS.

(A) Boarding House. The term "boarding house" as used in this regulation means any establishment regularly serving meals, on the average to five or more paying guests. The term includes a "guest home," "residential care home," "halfway house," and any other establishment providing room and board or board only, which is not an institution as defined in Regulation 1503 and Section 6363.6 of the Revenue and Taxation Code. The fact that guests may be recipients of welfare funds does not affect the application of tax. A person or establishment furnishing meals on the average to fewer than five paying guests during the calendar quarter is not considered to be engaged in the business of selling meals at retail.

(B) American Plan Hotel. The term "American Plan Hotel" as used in this regulation means a hotel which charges guests a fixed sum by the day, week, or other period for room and meals combined.

(C) Complimentary Food and Beverages. As used in this subdivision (a), the term "complimentary food and beverages" means food and beverages (including alcoholic and non-alcoholic beverages) which are provided to transient guests on a complimentary basis and:

1. There is no segregation between the charges for rooms and the charges for the food and beverages on the guests' bills, and

2. The guests are not given an option to refuse the food and beverages in return for a discounted room rental.

(D) Average Retail Value of Complimentary Food and Beverages. The term "average retail value of complimentary food and beverages" (ARV) as used in this regulation means the total amount of the costs of the complimentary food and beverages for the preceding calendar year marked-up one hundred percent (100%) and divided by the number of rooms rented for that year. Costs of complimentary food and beverages include charges for delivery to the lodging establishment but exclude discounts taken and sales tax reimbursement paid to vendors. The 100% markup factor includes the cost of food preparation labor by hotel employees, the fair rental value of hotel facilities used to prepare or serve the food and beverages, and profit.

(E) Average Daily Rate. The term "average daily rate" (ADR) as used in this regulation means the gross room revenue for the preceding calendar year divided by the number of rooms rented for that year. "Gross room revenue" means and includes the full charge to the hotel customers but excludes separately stated occupancy taxes, revenue from contract and group rentals which do not qualify for complimentary food and beverages, and revenue from special packages (e.g., New Year's Eve packages which include food and beverages as well as guest room accommodations), unless it can be documented that the retail value of the food and beverages provided as a part of the special package is 10% or less of the total package charge as provided in subdivision (a)(2)(B). "Number of rooms rented for that year" means the total number of times all rooms have been rented on a nightly basis provided the revenue for those rooms is included in the "gross room revenue". For example, if a room is rented out for three consecutive nights by one guest, that room will be counted as rented three times when computing the ADR.

(2) APPLICATION OF TAX.

(A) In General. Tax applies to sales of meals or hot prepared food products (see (e) below) furnished by restaurants, concessionaires, hotels, boarding houses, soda fountains, and similar establishments whether served on or off the premises. In the case of American Plan hotels, special packages offered by hotels, e.g., a New Year's Eve package as described in subdivision (a)(1)(E), and boarding houses, a reasonable segregation must be made between the charges for rooms and the charges for the meals, hot prepared food products, and beverages. Charges by hotels or boarding houses for delivering meals or hot prepared food products to, or serving them in, the rooms of

guests are includable in the measure of tax on the sales of the meals or hot prepared food products whether or not the charges are separately stated. (Caterers, see (h) below.) Sales of meals or hot prepared food products by restaurants, concessionaires, hotels, boarding houses, soda fountains, and similar establishments to persons such as event planners, party coordinators, or fundraisers, which buy and sell on their own account, are sales for resale for which a resale certificate may be accepted (see subdivision (h)(3)(C)2.).

Soufflé cups, straws, paper napkins, toothpicks and like items that are not of a reusable character which are furnished with meals or hot prepared food products are sold with the meals or hot prepared food products. Sales of such items for such purpose to persons engaged in the business of selling meals or hot prepared food products are, accordingly, sales for resale.

(B) Complimentary Food and Beverages. Lodging establishments which furnish, prepare, or serve complimentary food and beverages to guests in connection with the rental of rooms are consumers and not retailers of such food and beverages when the retail value of the complimentary food and beverages is "incidental" to the room rental service regardless of where within the hotel premises the complimentary food and beverages are served. For complimentary food and beverages to qualify as "incidental" for the current calendar year, the average retail value of the complimentary food and beverages (ARV) furnished for the preceding calendar year must be equal to or less than 10% of the average daily rate (ADR) for that year.

If a hotel provides guests with coupons or similar documents which may be exchanged for complimentary food and beverages in an area of the hotel where food and beverages are sold on a regular basis to the general public (e.g., a restaurant), the hotel will be considered the consumer and not the retailer of such food and beverages if the coupons or similar documents are non-transferable and the guest is specifically identified by name. If the coupons or similar documents are transferable or the guest is not specifically identified, food and beverages provided will be considered sold to the guest at the fair retail value of similar food and beverages sold to the general public. In the case of coupons redeemed by guests at restaurants not operated by the lodging establishment, the hotel will be considered the consumer of food and beverages provided to the hotel's guests and tax will apply to the charge by the restaurant to the hotel.

Lodging establishments are retailers of food and beverages which do not qualify as "incidental" and tax applies as provided in subdivision (a)(2)(A) above. Amounts paid by guests for food and beverages in excess of a complimentary allowance are gross receipts subject to the tax. Lodging establishments are retailers of otherwise complimentary food and beverages sold to non-guests.

In the case of hotels with concierge floor, club level or similar programs, the formula set forth above shall be applied separately with respect to the complimentary food and beverages furnished to guests who participate in the concierge, club or similar program. That is, the concierge, club or similar program will be deemed to be an independent hotel separate and apart from the hotel in which it is operated. The ADR and the retail value of complimentary food and beverages per occupied room will be computed separately with respect to the guest room accommodations entitled to the privileges and amenities involved in the concierge, club or similar program.

The following example illustrates the steps in determining whether the food and beverages are complimentary:

FORMULA: ARV ÷ ADR ≤ 10%

Average Daily Rate (ADR):

Room Revenue	$9,108,000
Rooms Rented	74,607
ADR ($9,108,000 ÷ 74,607)	$122.08

Average Retail Value of Complimentary

Food and Beverages (ARV):

Complimentary Food Cost	$169,057
Complimentary Beverage Cost	52,513
Total	$221,570
Add 100% Markup	221,570
Average Retail Value	$443,140
ARV per occupied room ($443,140 ÷ 74,607)	$5.94

Application of Formula: $5.94 ÷ $122.08 = 4.87%

In the above example, the average retail value of the complimentary food and beverages per occupied room for the preceding calendar year is equal to or less than 10% of the average daily rate. Therefore, under the provisions of this subdivision (a)(2)(B), the complimentary food and beverages provided to guests for the current calendar year qualify as "incidental". The lodging establishment is the consumer and not the retailer of such food and beverages. This computation must be made annually.

When a lodging establishment consists of more than one location, the operations of each location will be considered separately in determining if that location's complimentary food and beverages qualify as incidental.

(b) "DRIVE-INS." Tax applies to sales of food products ordinarily sold for immediate consumption on or near a location at which parking facilities are provided primarily for the use of patrons in consuming the products purchased at the "drive-in" establishment, even though such products are sold on a "take out" or "to go" order and are actually packaged or wrapped and taken from the premises of the retailer. Food products when sold in bulk, i.e., in quantities or in a form not suitable for consumption on the retailer's premises, are not regarded as ordinarily sold for immediate consumption on or near the location at which parking facilities are provided by the retailer. Accordingly, with the exception of sales of hot prepared food products (see (e) below) and sales of cold food under the 80-80 rule (see (c) below), sales of ice cream, doughnuts, and other individual food items in quantities obviously not intended for consumption on the retailer's premises, without eating utensils, trays or dishes and not consumed on the retailer's premises, are exempt from tax. Any retailer claiming a deduction on account of food sales of this type must support the deduction by complete and detailed records.[1]

(c) COLD FOOD SOLD ON A "TAKE-OUT" ORDER.

(1) GENERAL.

(A) Seller Meeting Criteria of 80-80 Rule. When a seller meets both criteria of the 80-80 rule as explained in subdivision (c)(3) below, tax applies to sales of cold food products (including sales for a separate price of hot bakery goods and hot beverages such as coffee) in a form suitable for consumption on the seller's premises even though such food products are sold on a "take-out" or "to go" order. Sales of cold food products which are suitable for consumption on the seller's premises are subject to the tax no matter how great the quantity purchased, e.g., 40 one-half pint containers of milk. Except as provided elsewhere in this regulation, tax does not apply to sales of food products which are furnished in a form not suitable for consumption on the seller's premises.

Operative April 1, 1996, although a seller may meet both criteria of the 80-80 rule, he or she may elect to separately account for the sale of "take-out" or "to go" orders of cold food products which are in a form suitable for consumption

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[1]The records acceptable in support of such a deduction are:
(a) A sales ticket prepared for each transaction claimed as being tax exempt showing:
(1) Date of the sale,
(2) The kind of merchandise sold,
(3) The quantity of each kind of merchandise sold,
(4) The price of each kind of merchandise sold,
(5) The total price of merchandise sold,
(6) A statement to the effect that the merchandise purchased is not to be consumed on or near the location at which parking facilities are provided by the retailer, and
(b) A daily sales record kept in sufficient detail to permit verification by audit that all gross receipts from sales have been accounted for and that all sales claimed as being tax exempt are included therein.

on the seller's premises. The gross receipts from the sale of those food products shall be exempt from the tax provided the seller keeps a separate accounting of these transactions in his or her records. Tax will remain applicable to the sale of food products as provided in subdivisions (a), (b), (e), or (f) of this regulation. Failure to maintain the required separate accounting and documentation claimed as exempt under this subdivision will revoke the seller's election under this subdivision.

(B) Seller Not Meeting Criteria of 80-80 Rule. When a seller does not meet both criteria of the 80-80 rule as explained in subdivision (c)(3) below , tax does not apply to sales of cold food products (including sales for a separate price of hot bakery goods and hot beverages such as coffee) when sold on a "take-out" or "to go" order.

(2) DEFINITIONS.

(A) For purposes of this subdivision (c), the term "suitable for consumption on the seller's premises" means food products furnished:

1. In a form which requires no further processing by the purchaser, including but not limited to cooking, heating, thawing, or slicing, and

2. In a size which ordinarily may be immediately consumed by one person such as a large milk shake, a pint of ice cream, a pint of milk, or a slice of pie. Cold food products (excluding milk shakes and similar milk products) furnished in containers larger in size than a pint are considered to be in a form not suitable for immediate consumption.

Pieces of candy sold in bulk quantities of one pound or greater are deemed to be sold in a form not suitable for consumption on the seller's premises.

The term does not include cold food products which obviously would not be consumed on the premises of the seller, e.g., a cold party tray or a whole cold chicken.

(B) For purposes of this subdivision (c), the term "seller's premises" means the individual location at which a sale takes place rather than the aggregate of all locations of the seller. For example, if a seller operates several drive-in and fast food restaurants, the operations of each location stand alone and are considered separately in determining if the sales of food products at each location meet the criteria of the 80-80 rule.

When two or more food-selling activities are conducted by the same person at the same location, the operations of all food related activities will be considered in determining if the sales of food products meet the criteria of the 80-80 rule. For example, if a seller operates a grocery store and a restaurant with no physical separation other than separate cash registers, the grocery store operations will be included in determining if the sales of food products meet the criteria of the 80-80 rule. When there is a physical separation where customers of one operation may not pass freely into the other operation, e.g., separate rooms with separate entrances but a common kitchen, each operation will be considered separately for purposes of this subdivision (c).

(3) 80-80 Rule. Tax applies under this subdivision (c) only if the seller meets *both* of the following criteria:

(A) more than 80 percent of the seller's gross receipts are from the sale of food products, and

(B) more than 80 percent of the seller's retail sales of food products are taxable as provided in subdivisions (a), (b), (e), and (f) of this regulation.

Sales of alcoholic beverages, carbonated beverages, or cold food to go not suitable for immediate consumption should not be included in this computation. Any seller meeting both of these criteria and claiming a deduction for the sale of cold food products in a form not suitable for consumption on the seller's premises must support the deduction by complete and detailed records of such sales made.

(d) PLACES WHERE ADMISSION IS CHARGED.

(1) GENERAL. Tax applies to sales of food products when sold within, and for consumption within, a place the entrance to which is subject to an admission charge, during the period when the sales are made, except for national and state parks and monuments, and marinas, campgrounds, and recreational vehicle parks.

(2) DEFINITIONS**.**

(A) "Place" means an area the exterior boundaries of which are defined by walls, fences or otherwise in such a manner that the area readily can be recognized and distinguished from adjoining or surrounding property. Examples include buildings, fenced enclosures and areas delimited by posted signs.

(B) "Within a place" means inside the door, gate, turnstile, or other point at which the customer must pay an admission charge or present evidence, such as a ticket, that an admission charge has been paid. Adjacent to, or in close proximity to, a place is not within a place.

(C) "Admission charge" means any consideration required to be paid in money or otherwise for admittance to a place. "Admission charge" does not include:

1. Membership dues in a club or other organization entitling the member to, among other things, entrance to a place maintained by the club or organization, such as a fenced area containing a club house, tennis courts, and a swimming pool. Where a guest is admitted to such a place only when accompanied by or vouched for by a member of the club or organization, any charge made to the guest for use of facilities in the place is not an admission charge.

2. A charge for a student body card entitling the student to, among other things, entrance to a place, such as entrance to a school auditorium at which a dance is held.

3. A charge for the use of facilities within a place to which no entrance charge is made to spectators. For example, green fees paid for the privilege of playing a golf course, a charge made to swimmers for the use of a pool within a place, or a charge made for the use of lanes in a public bowling place.

(D) "National and state parks and monuments" means those which are part of the National Park System or the State Park System. The phrase does not include parks and monuments not within either of those systems, such as city, county, regional, district or private parks.

(3) Presumption That Food Is Sold for Consumption Within a Place.

When food products are sold within a place the entrance to which is subject to an admission charge, it will be presumed, in the absence of evidence to the contrary, that the food products are sold for consumption within the place. Obtaining and retaining evidence in support of the claimed tax exemption is the responsibility of the retailer. Such evidence may consist, for example, of proof that the sales were of canned jams, cake mixes, spices, cooking chocolate, or other items in a form in which it is unlikely that such items would be consumed within the place where sold.

(4) Food Sold to Students. The exemption otherwise granted by Section 6363 does not apply to sales of food products to students when sold within, and for consumption within, a place the entrance to which is subject to an admission charge, and such sales are subject to tax except as provided in (p) of this regulation. For example, when food products are sold by a student organization to students or to both students and nonstudents within a place the entrance to which is subject to an admission charge, such as a place where school athletic events are held, the sales to both students and nonstudents are taxable.

(e) HOT PREPARED FOOD PRODUCTS.

(1) GENERAL. Tax applies to all sales of hot prepared food products unless otherwise exempt. "Hot prepared food products" means those products, items, or components which have been prepared for sale in a heated condition and which are sold at any temperature which is higher than the air temperature of the room or place where they are sold. The mere heating of a food product constitutes preparation of a hot prepared food product, e.g., grilling a sandwich, dipping a sandwich bun in hot gravy, using infra-red lights, steam tables, etc. If the sale is intended to be of a hot food product, such sale is of a hot food product regardless of cooling which incidentally occurs. For example, the sale of a toasted sandwich intended to be in a heated condition when sold, such as a fried ham sandwich on toast, is a sale of a hot prepared food product even though it may have cooled due to delay. On the other hand, the sale of a toasted sandwich which is not intended to be in a heated condition when sold, such as a cold tuna sandwich on toast, is not a sale of a hot prepared food product. When a single price has been established for a combination of hot and cold food items, such as a meal or dinner which includes cold components or side items, tax applies to the entire established price regardless of itemization on the sales check. The inclusion of any hot food product in an otherwise cold combination of food products sold for a single established price, results in the tax applying to the entire

established price, e.g., hot coffee served with a meal consisting of cold food products, when the coffee is included in the established price of the meal. If a single price for the combination of hot and cold food items is listed on a menu, wall sign or is otherwise advertised, a single price has been established. Except as otherwise provided in (b), (c), (d) or (f) of this regulation, or in Regulation 1574, tax does not apply to the sale for a separate price of bakery goods, beverages classed as food products, or cold or frozen food products. Hot bakery goods and hot beverages such as coffee are hot prepared food products but their sale for a separate price is exempt unless taxable as provided in (b), (c), (d) or (f) of this regulation, or in Regulation 1574. Tax does apply if a hot beverage and a bakery product or cold food product are sold as a combination for a single price. Hot soup, bouillon, or consommé is a hot prepared food product, which is not a beverage.

(2) AIR CARRIERS ENGAGED IN INTERSTATE OR FOREIGN COMMERCE. Tax does not apply to the sale, storage, use, or other consumption of hot prepared food products sold by caterers or other vendors to air carriers engaged in interstate or foreign commerce for consumption by passengers on such air carriers, nor to the sale, storage, use, or other consumption of hot prepared food products sold or served to passengers by air carriers engaged in interstate or foreign commerce for consumption by passengers on such air carriers. "Air carriers" are persons or firms in the business of transporting persons or property for hire or compensation, and include both common and contract carriers. "Passengers" do not include crew members. Any caterer or other vendor claiming the exemption must support it with an exemption certificate from the air carrier substantially in the form prescribed in Appendix A of this regulation.

(f) FOOD FOR CONSUMPTION AT FACILITIES PROVIDED BY THE RETAILER. Tax applies to sales of sandwiches, ice cream, and other foods sold in a form for consumption at tables, chairs, or counters or from trays, glasses, dishes, or other tableware provided by the retailer or by a person with whom the retailer contracts to furnish, prepare, or serve food products to others.

A passenger's seat aboard a train, or a spectator's seat at a game, show, or similar event is not a "chair" within the meaning of this regulation. Accordingly, except as otherwise provided in (c), (d), and (e) above, tax does not apply to the sale of cold sandwiches, ice cream, or other food products sold by vendors passing among the passengers or spectators where the food products are not "for consumption at tables, chairs, or counters or from trays, glasses, dishes, or other tableware provided by the retailer."

(g) TIPS AND SERVICE CHARGES.

No employer shall collect, take, or receive any gratuity or a part thereof, paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of such gratuity, or require an employee to credit the amount, or any part thereof, of such gratuity against and as a part of the wages due the employee from the employer. (Labor Code section 351.) If this prohibition is violated, any amount of such gratuities received by the employer will be considered a part of the gross receipts of the employer and subject to the tax.

Amounts designated as service charges, added to the price of meals are a part of the selling price of the meals and, accordingly, must be included in the retailer's gross receipts subject to tax even though such service charges are made in lieu of tips and are paid over by the retailer to employees.

(h) CATERERS.

(1) DEFINITION

The term "caterer" as used in this regulation means a person engaged in the business of serving meals, food, or drinks on the premises of the customer, or on premises supplied by the customer, including premises leased by the customer from a person other than the caterer, but does not include employees hired by the customer by the hour or day.

(2) SALES TO CATERERS.

A caterer generally is considered to be the consumer of tangible personal property normally used in the furnishing and serving of meals, food or drinks, except for separately stated charges by the caterer for the lease of tangible personal property or tangible personal property regarded as being sold with meals, food or drinks such as disposable plates, napkins, utensils, glasses, cups, stemware, place mats, trays, covers and toothpicks.

(3) SALES BY CATERERS.

(A) Caterer as Retailer. Tax applies to the entire charge made by caterers for serving meals, food, and drinks, inclusive of charges for food, the use of dishes, silverware, glasses, chairs, tables, etc., used in connection with serving meals, and for the labor of serving the meals, whether performed by the caterer, the caterer's employees or subcontractors. Tax applies to charges made by caterers for preparing and serving meals and drinks even though the food is not provided by the caterers. Tax applies to charges made by caterers for hot prepared food products as in (e) above whether or not served by the caterers. A caterer who separately states or itemizes charges for the lease of tangible personal property regardless of the use of the property will be deemed to be the lessor of such property. Tax applies in accordance with Regulation 1660 Leases of Tangible Personal Property – In General. Tax does not apply to charges made by caterers for the rental of dishes, silverware, glasses, etc., purchased by the caterer with tax paid on the purchase price if no food is provided or served by the caterers in connection with such rental.

(B) Caterers as Lessors of Property Unrelated to the Serving or Furnishing of Meals, Food, or Drinks by a Caterer.

1. When a caterer who is furnishing or serving meals, food, or drinks also rents or leases from a third party tangible personal property which the caterer does not use himself or herself and the property is not customarily provided or used within the catering industry in connection with the furnishing and serving of food or drinks, such as decorative props related solely to optional entertainment, special lighting for guest speakers, sound or video systems, dance floors, stages, etc., he or she is a lessor of such property. In such instance, tax applies to the lease in accordance with Regulation 1660.

2. When a person who in other instances is a caterer does not furnish or serve any meals, food, or drinks to a customer, but rents or leases from a third party tangible personal property such as dishes, linen, silverware and glasses, etc., for purposes of providing it to his or her customer, he or she is not acting as a caterer within the meaning of this regulation, but solely as a lessor of tangible personal property. In such instances tax applies to the lease in accordance with Regulation 1660.

(C) Caterers Planning, Designing and Coordinating Events.

1. Tax applies to charges by a caterer for event planning, design, coordination, and/or supervision if they are made in connection with the furnishing of meals, food, or drinks for the event. Tax does not apply to separately stated charges for services unrelated to the furnishing and serving of meals, food, or drinks, such as optional entertainment or any staff who do not directly participate in the preparation, furnishing, or serving of meals, food, or drinks, e.g., coat-check clerks, parking attendants, security guards, etc.

2. When a caterer sells meals, food, or drinks, and the serving of them, to other persons such as event planners, party coordinators, or fundraisers, who buy and sell the same on their own account or for their own sake, it is a sale for resale for which the caterer may accept a resale certificate. However, a caterer may only claim the sale as a resale if the caterer obtains a resale certificate in compliance with Regulation 1668. A person is buying or selling for his or her own account, or own sake, when such person has his or her own contract with a customer to sell the meals, food, or drinks to the customer, and is not merely acting on behalf of the caterer.

3. When a caterer sells meals, food or drinks and the serving of them to other persons who charge a fee for their service unrelated to the taxable sale, the separately stated fee is not subject to tax.

(D) Sales of Meals by Caterers to Social Clubs, Fraternal Organizations. Sales of meals to social clubs and fraternal organizations, as those terms are defined in subdivision (i) below, by caterers are sales for resale if such social clubs and fraternal organizations are the retailers of the meals subject to tax under subdivision (i) and give valid resale certificates therefor.

(E) Tips, Gratuities, or Service Charges.

An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts. A tip, gratuity, or service charge negotiated in advance of an event between the caterer and the customer is mandatory even though the amount or percentage is negotiated. A tip, gratuity, or service charge itemized on an invoice or billing by a caterer is not optional even if the invoice or billing itemizes with a notation such as “optional gratuity.” A gratuity is optional only if it is voluntarily added by the customer.

Examples of mandatory tips, gratuities, or service charges include:

“A 15% gratuity [or service charge] will be added to parties of 8 or more.”

"Suggested gratuity 15%," itemized on the invoice or bill by the caterer.

Tips, gratuities, and service charges are further discussed in subdivision (g).

(4) PREMISES.

GENERAL. Separately stated charges for the lease of premises on which meals, food, or drinks are served, are nontaxable leases of real property. Where a charge for leased premises is a guarantee against a minimum purchase of meals, food or drinks, the charge for the guarantee is gross receipts subject to tax. Where a person contracts to provide both premises and meals, food or drinks, the charge for the meals, food or drinks must be reasonable in order for the charge for the premises to be non taxable.

(5) PRIVATE CHEFS.

A private chef is generally not an employee of the customer, but an independent contractor who pays his or her own social security, federal and state income taxes. Such a private chef, who prepares and serves meals, food and drinks in the home of his or her customer is a caterer under this regulation.

(i) SOCIAL CLUBS AND FRATERNAL ORGANIZATIONS. "Social Clubs and Fraternal Organizations" as used herein include any corporation, partnership, association or group or combination acting as a unit, such as service clubs, lodges, and community, country, and athletic clubs.

The tax applies to receipts from the furnishing of meals, food, and drink by social clubs and fraternal organizations unless furnished: (1) exclusively to members; and also, (2) less frequently than once a week. Both these requirements must be met. If the club or organization furnishes meals, food or drink to nonmembers, all receipts from the furnishing of meals, food or drink are subject to tax whether furnished to members or nonmembers, including receipts on occasions when furnished exclusively to members. Meals, food or drink paid for by members are considered furnished to them even though consumed by guests who are not members.

(j) STUDENT MEALS.

(1) DEFINITIONS.

(A) "FOOD PRODUCTS". As used herein, the term "food products" as defined in Regulation 1602 (18 CCR 1602) includes food furnished, prepared, or served for consumption at tables, chairs, or counters, or from trays, glasses, dishes, or other tableware provided by the retailer or by a person with whom the retailer contracts to furnish, prepare or serve food to others.

(B) "MEALS". As used herein, the term "meals" includes both food and nonfood products, which are sold to students for an established single price at a time set aside for meals. If a single price for the combination of a nonfood product and a food product is listed on a menu or on a sign, a single price has been established. The term "meals" does not include nonfood products which are sold to students for a separate price and tax applies to the sales of such products. Examples of nonfood products are: carbonated beverages and beer. For the purpose of this regulation, products sold at a time designated as a "nutrition break", "recess", or similar break, will not be considered "meals".

(2) APPLICATION OF TAX.

(A) Sales by Schools, School Districts and Student Organizations. Sales of meals or food products for human consumption to students of a school by public or private schools, school districts, and student organizations, are exempt from tax, except as otherwise provided in (d)(4) above.

(B) Sales by Parent-Teacher Associations. Tax does not apply to the sale of, nor the storage, use or other consumption in this state of, meals and food products for human consumption furnished or served to the students of a school by parent-teacher associations. Parent-teacher associations qualifying under Regulation 1597 as consumers are not retailers of tangible personal property, which they sell. Accordingly, tax does apply to the sale to such associations of nonfood items such as carbonated beverages, containers, straws and napkins.

(C) Sales by Blind Vendors. Tax does not apply to the sale of meals or food products for human consumption to students of a school by any blind person (as defined in section 19153 of the Welfare and Institutions Code) operating a restaurant or vending stand in an educational institution under article 5 of chapter 6 of part 2 of division 10 of the Welfare and Institutions Code, except as otherwise provided in (d)(4) above.

(D) Sales by Caterers. The application of tax to sales by caterers in general is explained in subdivision (h) above. However, tax does not apply to the sale by caterers of meals or food products for human consumption to students of a school, if all the following criteria are met:

(1) The premises used by the caterer to serve the lunches to the students are used by the school for other purposes, such as sporting events and other school activities, during the remainder of the day;

(2) The fixtures and equipment used by the caterer are owned and maintained by the school; and

(3) The students purchasing the meals cannot distinguish the caterer from the employees of the school.

(k) EMPLOYEES' MEALS.

(1) IN GENERAL. Any employer or employee organization that is in the business of selling meals, e.g., a restaurant, hotel, club, or association, must include its receipts from the sales of meals to employees, along with its receipts from sales to other purchasers of meals, in the amount upon which it computes its sales tax liability. An employer or an employee organization selling meals only to employees becomes a retailer of meals and liable for sales tax upon its receipts from sales of meals if it sells meals to an average number of five or more employees during the calendar quarte-r.

(2) SPECIFIC CHARGE. The tax applies only if a specific charge is made to employees for the meals. Tax does not apply to cash paid an employee in lieu of meals. A specific charge is made for meals if:

(A) Employee pays cash for meals consumed.

(B) Value of meals is deducted from employee's wages.

(C) Employee receives meals in lieu of cash to bring compensation up to legal minimum wage.

(D) Employee has the option to receive cash for meals not consumed.

(3) NO SPECIFIC CHARGE. If an employer makes no specific charge for meals consumed by employees, the employer is the consumer of the food products and the non-food products, which are furnished to the employees as a part of the meals.

In the absence of any of the conditions under (k)(2) a specific charge is not made if:

(A) A value is assigned to meals as a means of reporting the fair market value of employees' meals pursuant to state and federal laws or regulations or union contracts.

(B) Employees who do not consume available meals have no recourse on their employer for additional cash wages.

(C) Meals are generally available to employees, but the duties of certain employees exclude them from receiving the meals and are paid cash in lieu thereof.

(4) MEALS CREDITED TOWARD MINIMUM WAGE. If an employee receives meals in lieu of cash to bring his or her compensation up to the legal minimum wage, the amount by which the minimum wage exceeds the amount otherwise paid to the employee is includable in the employer's taxable gross receipts up to the value of the meals credited toward the minimum wage.

For example, if the minimum rate for an eight-hour day is $46.00, and the employee received $43.90 in cash, and a lunch is received which is credited toward the minimum wage in the maximum allowable amount of $2.10, the employer has received gross receipts in the amount of $2.10 for the lunch.

(5) TAX REIMBURSEMENT. If a separately stated amount for tax reimbursement is not added to the price of meals sold to employees for which a specific charge is made, the specific charge will be regarded as being a tax-included charge for the meals.

(l) RELIGIOUS ORGANIZATIONS. Tax does not apply to sales of meals and food products for human consumption furnished or served by any religious organization at a social or other gathering conducted by it or under its auspices, if the purpose in furnishing or serving the meals and food products is to obtain revenue for the functions and activities of the organization and the revenue obtained from furnishing or serving the meals and food products is actually used in carrying on such functions and activities. For the purposes of this regulation, "religious organization"

means any organization the property of which is exempt from taxation pursuant to subdivision (f) of Section 3 of article XIII of the State Constitution.

(m) INSTITUTIONS. Tax does not apply to the sale of, nor the storage, use, or other consumption in this state of, meals and food products for human consumption furnished or served to and consumed by patients or residents of an "institution" as defined in Regulation 1503. Tax, however, does apply to the sale of meals and food products by an institution to persons other than patients or residents of the institution.

(n) MEAL PROGRAMS FOR LOW-INCOME ELDERLY PERSONS. Tax does not apply to the sale of, and the storage, use or other consumption in this state of, meals and food products for human consumption furnished or served to low-income elderly persons at or below cost by a nonprofit organization or governmental agency under a program funded by this state or the United States for such purposes.

(o) FOOD PRODUCTS, NONALCOHOLIC BEVERAGES AND OTHER TANGIBLE PERSONAL PROPERTY TRANSFERRED BY NONPROFIT YOUTH ORGANIZATIONS. See Regulation 1597 for application of tax on food products, nonalcoholic beverages and other tangible personal property transferred by nonprofit youth organizations.

(p) NONPROFIT PARENT-TEACHER ASSOCIATIONS. Nonprofit parent-teacher associations and equivalent organizations qualifying under Regulation 1597 are consumers and not retailers of tangible personal property, which they sell.

(q) MEALS AND FOOD PRODUCTS SERVED TO CONDOMINIUM RESIDENTS. Tax does not apply to the sale of and the storage, use, or other consumption in this state of meals and food products for human consumption furnished to and consumed by persons 62 years of age or older residing in a condominium and who own equal shares in a common kitchen facility; provided, that the meals and food products are served to such persons on a regular basis.

This exemption is applicable only to sales of meals and food products for human consumption prepared and served at the common kitchen facility of the condominium. Tax applies to sales to persons less than 62 years of age.

(r) "FREE" MEALS. When a restaurant agrees to furnish a "free" meal to a customer who purchases another meal and presents a coupon or card, which the customer previously had purchased directly from the restaurant or through a sales promotional agency having a contract with the restaurant to redeem the coupons or cards, the restaurant is regarded as selling two meals for the price of one, plus any additional compensation from the agency or from its own sales of coupons. Any such additional compensation is a part of its taxable gross receipts for the period in which the meals are served.

Tax applies only to the price of the paid meal plus any such additional compensation.

(s) FOOD STAMP COUPONS. Tax does not apply to tangible personal property, which is eligible to be purchased with federal food stamp coupons acquired pursuant to the Food Stamp Act of 1977 and so purchased. When payment is made in the form of both food stamps and cash, the amount of the food stamp coupons must be applied first to tangible personal property normally subject to the tax, e.g., nonalcoholic carbonated beverages. Retailers are prohibited from adding any amount designated as sales tax, use tax, or sales tax reimbursement to sales of tangible personal property purchased with food stamp coupons. (See paragraph (c) of Regulation 1602.5 for special reporting provisions by grocers.)

(t) HONOR SYSTEM SNACK SALES. An "honor system snack sale" means a system where customers take snacks from a box or tray and pay by depositing money in a container provided by the seller. Snacks sold through such a system may be subject to tax depending upon where the sale takes place. Sales of such snacks are taxable when sold at or near a lunchroom, break room, or other facility that provides tables and chairs, and it is contemplated that the food sold will normally be consumed at such facilities. Honor system snack sales do not include hotel room mini-bars or snack baskets.

Appendix A

California Sales Tax Exemption Certificate
Supporting Exemption Under Section 6359.1

The undersigned certifies that it is an air carrier engaged in interstate or foreign commerce and that the hot prepared food products purchased from_____will be consumed by passengers on its flights.

The undersigned further certifies that it understands and agrees that if the property purchased under this certificate is used by the purchaser for any purpose other than that specified above, the purchaser shall be liable for sales tax as if it were a retailer making a retail sale of the property at the time of such use, and the sales price of the property to it shall be deemed the gross receipts from such sale.

Date Certificate Given _____

Purchasing Air Carrier _____
(company name)

Address _____

Signed By _____
(signature of authorized person)

_____
(print or type name)

Title _____
(owner, partner, purchasing agent, etc.)

Seller's Permit No. (if any) _____

CALIFORNIA CODES
LABOR CODE SECTION 350 - 356

350. As used in this article, unless the context indicates otherwise:

(a) “Employer” means every person engaged in any business or enterprise in this state that has one or more persons in service under any appointment, contract of hire, or apprenticeship, express or implied, oral or written, irrespective of whether the person is the owner of the business or is operating on a concessionaire or other basis.

(b) “Employee” means every person, including aliens and minors, rendering actual service in any business for an employer, whether gratuitously or for wages or pay, whether the wages or pay are measured by the standard of time, piece, task, commission, or other method of calculation, and whether the service is rendered on a commission, concessionaire, or other basis.

(c) “Employing” includes hiring, or in any way contracting for, the services of an employee.

(d) "Agent" means every person other than the employer having the authority to hire or discharge any employee or supervise, direct, or control the acts of employees.

(e) “Gratuity” includes any tip, gratuity, money, or part thereof that has been paid or given to or left for an employee by a patron of a business over and above the actual amount due the business for services rendered or for goods, food, drink, or articles sold or served to the patron. Any amounts paid directly by a patron to a dancer employed by an employer subject to Industrial Welfare Commission Order No. 5 or 10 shall be deemed a gratuity.

(f) “Business” means any business establishment or enterprise, regardless of where conducted.

351. No employer or agent shall collect, take, or receive any gratuity or a part thereof that is paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of a gratuity, or require an employee to credit the amount, or any part thereof, of a gratuity against and as a part of the wages due the employee from the employer. Every gratuity is hereby declared to be the sole property of the employee or employees to whom it was paid, given, or left for. An employer that permits patrons to pay gratuities by credit card shall pay the employees the full amount of the gratuity that the patron indicated on the credit card slip, without any deductions for any credit card payment processing fees or costs that may be charged to the employer by the credit card company. Payment of gratuities made by patrons using credit cards shall be made to the employees not later than the next regular payday following the date the patron authorized the credit card payment.

353. Every employer shall keep accurate records of all gratuities received by him, whether received directly from the employee or indirectly by means of deductions from the wages of the employee or otherwise. Such records shall be open to inspection at all reasonable hours by the department.

354. Any employer who violates any provision of this article is guilty of a misdemeanor, punishable by a fine not exceeding one thousand dollars ($1,000) or by imprisonment for not exceeding 60 days, or both.

355. The Department of Industrial Relations shall enforce the provisions of this article. All fines collected under this article shall be paid into the State treasury and credited to the general fund.

356. The Legislature expressly declares that the purpose of this article is to prevent fraud upon the public in connection with the practice of tipping and declares that this article is passed for a public reason and can not be contravened by a private agreement. As a part of the social public policy of this State, this article is binding upon all departments of the State.

DATE: APRIL 25, 2006

TO: BOARD OF EQUALIZATION BUSINESS TAXES COMMITTEE

FROM: LARA DIAZ DUNBAR
VICE PRESIDENT, GOVERNMENT AFFAIRS & PUBLIC POLICY

SUBJECT: PROPOSED REVISIONS TO REGULATION 1603, TAXABLE SALES OF FOOD PRODUCTS, REGARDING THE APPLICATION OF TAX TO CHARGES FOR MANDATORY AND OPTIONAL GRATUITIES

INTERESTED PARTIES PROPOSAL FOR BUSINESS TAXES COMMITTEE
1ST INTERESTED PARTIES MEETING – JUNE 1, 2006

ISSUE

Whether the amount of tips and gratuities which are left by restaurant customers and which, according to California Labor Coe Section 351, are the sole property of the employees of the restaurant, should be included in the taxable measure of gross receipts for purposes of the application of sales tax.

CONCLUSION

State law requires that any amount left by a restaurant customer as a tip or gratuity becomes the property of the employees of the restaurant. There is no basis in law for a Board of Equalization (Board) regulatory policy or audit procedure that results in the imposition of a retail sales tax on the property of the employees of the restaurant. We conclude that no amount of tips or gratuities which belong to the employees and is passed on to the employees in compliance with Labor Code Section 351 should be included in the taxable measure of gross receipts for purposes of calculating the sales tax.

BACKGROUND

Recently, restaurant owners around California have been experiencing a more aggressive policy by Board of Equalization (Board) auditors on the issue of "voluntary" versus "mandatory" tips and gratuities left by dining room patrons. When the audits are completed, these owners have been presented with bills for unpaid sales tax (Notices of Determination) amounting to thousands of dollars per restaurant. Of course, by the time the audits are complete it is impossible to collect from the customers and the restaurant owners are forced to pay these tax bills out of their own pockets.

Historically, the Board has taken the position that "voluntary" tips are not subject to sales tax and "mandatory" tips are taxed. Board auditors have taken the position that almost any statement by the restaurant owner with regard to tipping shifts the psychology of the customer from a purely voluntary frame of mind to a feeling of being obligated to leave a tip – thus, making the tip non-voluntary and, therefore, taxable.

With regard to the Board audits, the problem arises, generally, in the case of tips left by large dining room parties. Often, a restaurant owner will, as a protection for his employees, print a statement on the menu to the extent that "An X% Gratuity/Tip May/Will be Added to the Bill for Parties Larger Than Y Individuals." Board auditors have claimed that this statement "obligates" the customer to pay a tip and makes the tip subject to sales tax.

We believe these distinctions are made moot by the fact that tips are the property of the employees of the restaurant and, as such, are not subject to a sales tax imposed on the restaurant owner by the Board.

State Labor Code section 351 clearly provides that *any* amount of tip/gratuity left by patrons is the property of the employees for whom the gratuity was left and *no portion* may be kept by the restaurant owner for any reason. Further, recent changes in Section 351 strengthen the employees claim on all types of tips, including tips left by means of a credit card.

The amendments to Section 351 specify how restaurant owners and others are to treat tips and gratuities left by credit card. Under new law, for tips left by credit card, employers are not even allowed to deduct credit card processing fees or charges and must pass on to employees 100% of the amount left as gratuities. In addition, the amendments eliminate an exemption from these rules. Old law contained an exemption from this pass-through rule for certain employees with guaranteed wages or salaries. The amendments to Section 351 eliminate this exemption, making *any* tip left for *any* employee subject to the pass-through rule.

In other words, under new law *all* tips left by customers (whether "voluntary" or not) are not the property of the restaurant owner and must be passed on to the employees. We believe the law prevents the Board from imposing on restaurants a retail sales tax on property (i.e., tips and gratuities) that belongs to employees and to which the restaurants have no right whatsoever.

In fact, Board Regulation 1603(g) seems to provide for this same policy. Regulation 1603 provides:

> *No employer shall collect, take, or receive any gratuity or a part thereof, paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of such gratuity, or require an employee to credit the*

amount, or any part thereof, of such gratuity, against and as a part of the wages due the employee from the employer.

The penalty for violating this prohibition, according to Regulation 1603, is the inclusion of the amount of gratuities kept by the employer in the taxable gross receipts of the restaurant. The regulation leaves the reader with the belief that if the restaurant owner complies with Section 351 and passes 100% of the tips/gratuities on to employees, the tips/gratuities then would NOT be included in taxable gross receipts and would NOT be subject to sales tax.

Board Auditors Continue to Impose Tax on Restaurant Owners

Despite these facts, many Board auditors have pursued a policy that *any* tip is subject to sales tax if the restaurant owner prints a statement in the menu that a tip may/will be added to the bill of parties over a certain size. Board auditors have considered these tips "mandatory" and, therefore, taxable. Even if the patron decides not to leave the recommended amount, Board auditors have pursued the policy that *any* tip that is printed on a credit card receipt, as opposed to handwritten in, is also mandatory no matter the size of the dining party.

But, at least in one audit, a Board auditor opined that a statement on the menu that "An X% Tip *May* be Added" (emphasis added) was sufficient to show that a tip was voluntary and, therefore, not taxable.

Finally, Board audit policy does not appear to take into account the recent changes in Section 351. Despite the fact that tips left for employees clearly are not the property of the restaurant, Board auditors continue to include tips and gratuities in their calculations of the sales tax base as if these dollars are the property of the restaurant owner.

Board Regulations and Audit Procedures Must be Updated to Reflect Current Law

Restaurant owners are confused by these rules and the inconsistent application of the policy by Board auditors and need clarification so that they may correctly apply the sales tax law and avoid unpaid sales tax bills. Although they know tips and gratuities are the sole property of the employees, they are still being presented with Notices of Determination and required to pay sales tax based on these tips and gratuities.

Sales Tax Would Still Apply to Service Charges Included in Catering Type Contracts That Provide for an All-Inclusive Price for Meals Served

The Board's audit policy appears to have evolved from a regulation (Regulation 1603 (h)) written to apply to caterers – persons who negotiate contracts with their customers to serve meals on the premises of the *customer*. With respect to *caterers*, the regulation

exempts a completely voluntary tip from the taxable amount of the catering contract, but taxes a negotiated (i.e., "mandatory") tip. (Reg.1603(h)(3)(E).)

With regard to ***restaurants***, the regulation contains a general rule that "*amounts designated as service charges...must be included in the retailer's gross receipts subject to tax.*" (Reg. 1603(g).)

A Reasonable Policy Toward Taxation of Gratuities

With the recent amendments to Labor Code Section 351 making it clear that ANY AND ALL tips and gratuities belong solely to the employees and cannot be retained by the restaurant owner, we believe it is time for the Board to amend its regulations and audit procedures to reflect the current state of the law. We believe the adoption of the following policy will accurately reflect the restaurant dining room setting and will accurately apply the statutory provisions of the Sales and Use Tax Law:

- The amount of gratuities negotiated prior to a meal and added to the price of the meal should be included in gross receipts subject to tax;

- A gratuity authorized by a restaurant patron whether printed on a credit card receipt or handwritten on a receipt should be excluded from gross receipts subject to tax so long as it is not added to the price of the meal and is merely added to restaurant bill;

See Attached Discussion

DISCUSSION

General Rule:

California imposes a sales tax on retailers for the privilege of selling tangible personal property and the tax is based on a percentage of the gross receipts from the sale of tangible personal property. (Revenue and Taxation Code Section 6051.) A "sale" includes "the furnishing, preparing, or serving for a consideration of food, meals, or drinks." (RTC sec. 6006.) The retailer's "gross receipts" include:

- "the total amount of the sale…of the retail sales of retailers, valued in money, whether received in money or otherwise…"; (RTC sec. 6012(b) and includes
- "any services *that are part of the sale"* (emphasis added) (RTC sec. 6012(b)(1).).

Finally, although the law exempts the sale of "food products for human consumption," the exemption does not apply when the food products are served as meals on or off the premises of the retailer. (RTC sec. 6359.)

Tips and Gratuities:

The Sales and Use Tax Law (Division 2, Part 1 of the Revenue and Taxation Code) provides no statutory guidance on the tax treatment of tips and gratuities. In regulation and audit policy, however, the Board has developed a practice of taxing "mandatory" tips/gratuities and not taxing "voluntary" tips/gratuities.

CATERERS: The Board's policy with regard to the taxation of tips is clearly spelled out for **caterers** in Regulation 1603 *Taxable Sales of Food Products:*

> *"An optional tip or gratuity is not subject to tax. A mandatory tip, gratuity, or service charge is included in taxable gross receipts." (Regulation 1603(h)(3)(E) Sales by Caterers; Tips, Gratuities, or Services.)*

Although a rationale for this policy seems to be lost to history, it appears that the Board's regulatory policy developed around the principal that if the tip is included in the price of the meal served, then the tip is included in taxable gross receipts. (See RTC sec. 6012.) In fact, the regulation above provides "(a) tip, gratuity, or service charge negotiated in advance of an event between the caterer and the customer is mandatory even though the amount or percentage is negotiated." Further, the regulation provides that a tip itemized on a catering invoice or billing is taxable even if the invoice provides that the tip is an "optional gratuity." With regard to the catering customer's say in the matter, the only regulatory guidance is that "a gratuity is 'optional' (and, therefore, non-taxable) only if it is voluntarily added by the customer." (Reg. 1603(h)(3)(E).)

Typically, a catering contract is negotiated between the caterer and customer well in advance of the served meal. The customer agrees to a lump sum price for a served meal including the cost of the meal plus other services and goods such as delivery, service, plates and utensils, tip, gratuity or service charge. Once the negotiations have ended, the customer typically enters into a contract with the caterer and is then contractually bound to pay the set price to the caterer. In this setting, the price of the meal appears to include a tip that, under RTC section 6012, would be included in taxable gross receipts.

RESTAURANTS: The question is does this Board regulatory policy regarding taxation of tips in connection with catering contracts apply to **restaurant owners and their dining room patrons?** Regulation 1603 defines "caterers" as "person(s) engaged in the business of serving meals, food, or drinks *on the premises of the customer*." (Reg. 1603(h)(1).) Restaurants do not fit this definition as they serve meals to walk-in customers and reservation customers in the restaurant dining room.

So, do restaurants have guidance regarding the taxation of tips provided by dining room patrons? Again, the Sales and Use Tax Law provides no statutory guidance for restaurants. And, as discussed above, restaurants do not fit into the category of "caterer" for purposes of Regulation 1603.

Regulation 1603(g) does provide some general guidance on the treatment of tips and service charges. First, the regulation provides that no employer shall retain a portion of any gratuity or deduct any portion of a gratuity from the wages of an employee. Any violation of this provision results in the inclusion of the amount retained as part of the employers gross receipts and subject to sales tax. This regulation is based on the provisions of Labor Code 351 which clearly provides that gratuities of any kind are the sole property of the employee or employees for whom the customer left the gratuity. A recent amendment to Section 351 provides that gratuities paid by credit card are also the sole property of the employee and must be paid to the employee not later than the next regular payday. No distinction is made between gratuities written in by the customer or amounts authorized by the customer and printed out on the receipt.

Regulation 1603(g) also provides that "service charges, added to the price of meals are a part of the selling price...and…must be included in the retailer's gross receipts subject to tax even though such service charges are made in lieu of tips and are paid over … to employees."

BOARD PRACTICE: This is the extent of the statutory and regulatory guidance available to restaurant owners. Unfortunately, Board staff has developed a practice of applying the catering rule of distinguishing between "voluntary" and "mandatory" tips and has published this practice as official advice to restaurant owners in Board publications (see Publication 22 - *Tax Tips for the Dining & Beverage Industry: Sales and Use Taxes* and Publication 115 – *Applying Sale Tax to Tips and Related Payments).*

Board auditors have established the practice of including in gross receipts the amount of any tip that is printed on a receipt (typically for a credit card transaction) as opposed to a

tip that is handwritten by the customer. In fact, the Board's Sales and Use Tax Audit Manual reflects this merger of the catering rule with restaurant practice. (See Sales and Use Tax Audit Manual Section 0809.20.) The auditor's presumption is that a printed amount for a tip is "mandatory" and, therefore subject to tax. Recently, on at least one occasion, a Board auditor simply applied tax to all tips provided to parties of eight or more at a restaurant which had the following notice printed on its menu: "A 17% Gratuity Will be Added for Parties of Eight or More." The fact that the customer was consulted on each occasion after the meal was served and authorized a gratuity which many times was either higher or lower than the suggested 17% was irrelevant to the auditor.

Board Audit Policy Should Conform to Restaurant Dining Room Practice and Current Law Relating to Employee Ownership of Tips and Gratuities:

We believe the current Board policy is not supported in statute or regulation and we believe the Board's practice of using the catering rules on taxing tips is inappropriate in the restaurant dining room setting. The policy should be amended to reflect the actual practice of restaurant owners and should recognize the factual distinctions between the dining room setting and a catering operation.

Most importantly, we believe the Board does not have statutory or regulatory authority to impose a retail sales tax on restaurant owners based on tips and gratuities that are the property of the employees.

Restaurant patrons should not be required to pay sales tax on gratuities that are, by California law, not the property of the restaurant owner.

- Labor Code section 351 makes it clear that gratuities are the sole property of the employee. The restaurant owner is merely the conduit for payment of the gratuity to the employee.

- We unable to find authority for the Board to impose a sales tax on property not owned by the restaurant owner.

- Recent amendments to Labor Code section 351 (See Statutes of California, Chapter 876 (AB 2509), Approved by Governor, September 28, 2000.) make it clear that *any* gratuity added to a credit card transaction is the property of the employee or employees of the restaurant and may not be retained by the restaurant owner for any reason. No distinction is made between a handwritten amount for a tip or an amount that is printed on the credit card receipt.

- These amendments also eliminate an exemption previously contained in Section 351. Under old law, an employer could keep tips left for certain salaried employees or deduct the amount of tips left for these employees from their wages. The amendments eliminate this exemption making ALL tips left by customers the property of ANY and ALL employees.

- According to Regulation 1603(g), any amount of a gratuity that is retained by the restaurant owner is to be included in the taxable gross receipts of the restaurant and subjected to tax. Restaurant owners should be concerned with the implication of the inclusion of any gratuity in taxable gross receipts. Auditors have been including "mandatory" gratuities in taxable gross receipts and the question is raised as to whether the restaurant owner is unwittingly admitting guilt even though all amounts of gratuities received by the restaurant owner were promptly transmitted to employees.